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THE CREDIT AND CAPITAL MARKETS AT MIDSUMMER

The sustained high level of interest rates in the face of an obvious softening in business activity in recent months and the well publicized moderation of inflation has surprised even the most unflappable financial market observers. Though the prevailing view is still that money market rates and bond yields will soon come down somewhat, the mood in the credit and capital markets at midsummer nonetheless is distinctly uneasy.

Besides the concern regarding the course of Federal Reserve policy and the uncertain impact of the impending Government spending and tax cuts on the Federal budget deficit, the economy has demonstrated remarkable resilience over the past year. More importantly, despite the slowing of the price advance, inflationary expectations have yet to be dampened materially among lenders and investors. Accordingly, the behavior of interest rates in the period ahead could once again confound the forecasts and the money and capital markets experience further strains.

Large-Scale Borrowing In contrast with last year, the current slackening in economic activity has so far not been reflected in any meaningful reduction in business demands for short-term credit. Rather, financing by industry of late has been at levels more associated with boom conditions. Borrowing at commercial banks, which had fallen off for a time during the winter and early spring, rose by $12 billion in the April-June period, compared with a decline of $4½ billion in the second quarter of 1980. The growth in commercial and industrial loans continued strong into July, especially at the money center banks. At the same time, nonfinancial corporations have continued to make very active use of the commercial paper market in recent months. And borrowing from finance companies has been comparatively heavy, primarily reflecting the need of automobile dealers to finance growing inventories.

Meanwhile, despite the drop-off in new-car sales following the termination of the manufacturers' rebates at the end of March, consumer credit has expanded at a moderate, albeit uneven, pace; in the spring a year ago it declined by a record amount.

The volume of long-term financing likewise has been quite sizable. The growth of commercial mortgage debt has been slowed noticeably by the curtailed interest of the life insurance companies in this market. But even with the high interest rates and the drop in housing starts during the spring, and although mortgage credit is now being used much less for purposes other than housing, residential mortgage credit increased because of the higher average prices of homes being purchased.

Active Bond Market Despite the recent postponement of a number of issues owing to the peak borrowing costs, net new municipal bond financing in the January-June period totaled not far below last year's $8¼ billion figure. This occurred, moreover, in the face of a substantial cutback this year in the issuance of housing revenue bonds.

In the corporate market, the unprecedentedly high and volatile interest rates and the relative lack of enthusiasm of investors for fixed income obligations clearly put a damper on financing at times during the spring, especially private placement activity. Yet the $12¼ billion of net new offerings in the first half was still large by any standard except the second quarter of 1980, when interest rates plummeted and there was a stampede by manufacturing and finance companies to restructure balance sheets. In addition, foreign bond financing picked up in the second quarter, reflecting increased offerings by Canadian provincial governments and utilities. At the same time, corporations have continued to issue a significant amount of common stock so far this year, including AT&T's nearly $1 billion offering.

Government Financing Borrowing by the Federal agencies, except for Fannie Mae, has been unexpectedly heavy, partly to assist the residential market but also in support of farmers in obtaining mortgage credit. Taken together, borrowing by the Federal Home Loan banks and by the Farm Credit agencies came close to $13 billion during the first half, not much below the peak total in the same period last year. Agency financing was especially large in the second quarter because of stepped-up borrowing by the savings and loan associations from the Federal Home Loan banks.

Notwithstanding the greater-than-anticipated growth of Federal tax receipts, Treasury financing in the January-June period was up appreciably; the $35 billion of borrowing from the public in the January-June period was $10 billion larger than the amount raised by the Government in the money and capital markets in the first six months of 1980. Coupon financing has been particularly heavy as the Treasury has moved to extend the public debt.

Changing Investment Patterns Accompanying the large-scale borrowing have been some important shifts in sources of financing and in the investment policies of major institutions and individuals. Most significant, deposit growth at the thrift institutions has fallen well short even of the severely curtailed flows a year ago. Investors have taken advantage of the higher

interest rates being paid elsewhere and have dramatically increased their participation in the money market funds, which, in the six months through June, grew by an astonishing $53½ billion, some $23 billion more than the gain in all of 1980. Thus, although the savings and loan associations recently have been surprisingly active in the residential mortgage market, home buying has been financed increasingly through other methods, including direct loans from sellers, funds provided by corporations assisting in relocations and the payment of cash—in some instances derived from the "underground" economy.

Growth of Thrift Deposits and Money Market Funds
(In billions of dollars)

	1980		1981
	1st Half	2nd Half	1st Half
Savings and loan ass'ns			
Earning regular rates	—7.2	—4.8	—7.2
Other	24.1	29.3	14.4
Total	16.9	24.5	7.2
Mutual savings banks			
Earning regular rates	—4.9	—2.5	—3.0
Other	7.2	7.2	4.1
Total	2.3	4.7	1.1
Credit unions			
Earning regular rates	—.3	1.0	—3.0
Other	3.5	2.8	5.2
Total	3.2	3.8	2.2
Money market funds			
Conventional	31.0	—1.7	52.1
Tax-exempt	1.2	.3	1.4
Total	32.2	—1.4	53.5

The growth in investible funds of the pension funds thus far has been reasonably well maintained. Even so, they have been less than avid buyers of corporate bonds, generally preferring to invest short and to acquire more common stock. Private placement activity has been particularly hard hit because the life insurance companies have been placing greater emphasis on liquidity. With a growing earnings squeeze stemming from their underwriting losses, the fire and casualty insurance companies also have had a reduced amount of funds to invest, as well as less need for tax-exempt income. Accordingly, these companies have cut back on their buying of municipal securities while stepping up somewhat their takings of taxable bonds and equities.

Also, commercial banks, the other institutional mainstay of the municipal bond market, have reduced their buying of municipal securities, obtaining tax-exempt income, where needed, more through leasing activities and direct industrial revenue bond lending. The large volume of new tax-exempt securities has therefore been absorbed by individuals, both directly and through participation in bond funds, notably the unit investment trusts.

What's Ahead With economic activity certain to remain sluggish at least through the summer, the next several months should see some easing in short-term borrowing by business. But with a probable inventory bulge to be financed, profits under pressure and the large loan commitments made recently by commercial banks in connection with pending large mergers and acquisitions, corporate borrowing is still likely to be substantial. At the same time, assuming new-car sales pick up with the introduction of the 1982 models and the enactment of the tax cut, and also for seasonal reasons, consumer credit will probably expand more in the second half. All told, short-term financing, exclusive of Government borrowings, is projected to be down in the July-December period by less than $5 billion, and well above the same period of 1980.

The corporate bond market, on the other hand, should be busier during the remainder of this year. As the large corporate calendar confirms, many companies still are seeking to refinance some of their short-term debt and rebuild liquidity. When interest rates come down, there is sure to be another rush into the bond market. Additionally, capital spending programs will continue to require financing. And a number of company managements evidently prefer to rely to a greater degree now on long-term debt in order to leverage their equity and to hedge against the increased volatility of money market rates. Market conditions permitting, it is expected that there will be as much as $15 billion of net new corporate bond offerings, including private placements, during the second half, which would put the 1981 total not too far short of last year's record. Providing the stock market does not weaken much further in the coming months, many corporations doubtless will resort to equity financing as well, although the net amount of funds raised in this manner will be held down by increased retirements resulting from forthcoming acquisitions.

In all probability, the volume of municipal bond offerings also will be larger in the second half, though much will depend on the nature of the pending tax cuts. Needs for financing are sizable, and not all of the state and municipal bond issues postponed recently have as yet come to market, as indicated by the still high 30-day calendar. Moreover, the new guidelines published not long ago by the Treasury, which clarify the conditions for the issuance of up to $15 billion of new housing revenue bonds, are likely to result in some increase in the volume of such offerings; to date, only about $3½ billion of housing revenue bonds have been marketed during 1981.

Residential mortgage debt will probably expand a bit further during the rest of the year in spite of the current weakness in home building. In addition to the normal increase that occurs in this period, home mortgage financing will be bolstered by the continuing rise in housing prices, and probably by some pickup in sales of new and existing homes by the autumn. Commercial mortgage financing, however, is being materially affected by the high interest rates and will probably show no increase despite the prevailing strength of office building.

The Treasury's Needs In all likelihood, borrowing by the Federal agencies will be no greater in the second half. The Federal Home Loan banks presumably will need to raise a considerable amount of money in support of the residential mortgage market. But Fannie Mae is unlikely to do much borrowing, and financing by the Farm Credit agencies will be down seasonally. Nevertheless, Federal agency financing overall will still be sizable.

The Treasury's new money requirements in the July-September period are currently the subject of some debate because of the later-than-expected effective date of the scheduled tax cut. Officially, it is being estimated that Treasury financing in the third quarter will be well below the $16-19 billion projection made in the spring. This, however, sounds optimistic. Government revenues are being slowed by the softening in the economy while Federal spending continues to rise faster than the earlier official estimates, and the overage for the current fiscal year is sure to be increased by the overrun on interest on the public debt. In addition, the needs of the Federal Financing Bank have been bigger than anticipated. In any event, the Treasury's financing needs will be increasing seasonally during the third and fourth quarters. Assuming the tax cut, when enacted, is effective October 1, Government borrowing for all of the second half, at close to $45 billion, will be appreciably greater than in the first six months of the year.

Taken together, the volume of funds projected to be raised in the money and capital markets in the July-December period is put at around $195 billion, some $20 billion more than in the first six months.

Supplying the Funds Developments are in sight among the major sources of credit and investment funds which have implications for the credit and capital markets in the coming months.

First and foremost, until short-term interest rates come down significantly and the thrift institutions experience much less competition from the money market funds, their deposit flows will be limited and their mortgage lending constrained, although with the broadening use of the variable rate mortgage, savings and loan associations recently have begun to extend their portfolios. Likewise, mortgage financing on income-producing properties will stay tight and expensive until the life insurance companies are convinced that interest rates are truly easing and that inflation is headed downward permanently.

The corporate bond market, too, stands to remain under pressure. With the threat of pension funds under their management being switched, and until short-term borrowing costs have fallen to the point where policy loans no longer are a problem, the life insurance companies will be reluctant to make new commitments for private placements and unwilling to lengthen their investment portfolios through the purchase of publicly offered bonds. Similarly, as long as money market rates stay high and inflation worries persist, the corporate bond market is unlikely to attract much greater support from the private pension funds. Not only are portfolio managers showing interest in the stock market, but they are again emphasizing liquidity. State and local retirement funds are uneasy about lengthening investment portfolios as well, notwithstanding their established preference for corporates.

The municipal market perhaps faces the most problems. Though interest on the part of fire and casualty insurance companies in the tax-exempt market could revive somewhat with the seasonal increase in their cash flows, and the prospect of a turnaround in underwriting profits in 1982 may begin to influence portfolio policies later this year, significant further support is unlikely to be forthcoming for a while from this quarter. Similarly, the commercial banks are likely to show only limited interest in tax-exempt securities until business loan demand falls off more than now seems likely. But more important is the shadow being cast over the municipal bond market by the prospective lowering of personal tax rates and the provision included in the Congressional tax proposals to grant tax exemption to some portion of interest received on savings deposits. These changes are bound to dampen individual investor interest in the municipal market, both directly and through the bond funds.

As for the Government securities market, support from individuals and other noninstitutional investors presumably will continue as long as interest rates stay high. There will probably continue to be some demand for Treasury securities from the money market funds. Businesses, as they rebuild liquidity, should have a limited appetite for Governments. And commercial banks may be purchasers of Treasuries to a degree, given prevailing yields. But it is difficult to see other institutional investors appreciably increasing their takings of Government securities in the coming months. Meanwhile, foreign investors, on balance, liquidated Governments during the second quarter, as many central banks moved to support their currencies in the international exchange markets, and they may again be net sellers in the second half. In addition, $2.4 billion of "Carter" bonds issued earlier to foreigners will have to be financed since they will be running off in the coming months.

Interest Rate Implications The prospect that overall demands for short-term credit will remain relatively large through the second half of the year would seem to cast doubt on the view held in some quarters that money market rates will decline appreciably in the coming months. Even more questionable is the likelihood of a significant drop in bond yields and other long-term interest rates in view of the increased volume of net new corporate and municipal bonds expected to be issued and the accompanying step-up in the amount of Treasury offerings. However, Federal Reserve policy—along with the market's expectations as to the Fed's actions—and the reactions of lenders and investors to the tax cuts and to developments on the inflation front will be the major factors affecting the behavior of interest rates during the rest of 1981.

Should the months ahead bring evidence of a renewed speed-up in prices and costs and a strengthening of economic activity, monetary policy would surely be tightened further and both money market rates and long-term yields would come under upward pressure. If, as seems more likely, the economy remains sluggish and there is a modest firming of prices, Federal Reserve policy, in all likelihood, will stay on its present course. In this event, money market rates may drift lower until business picks up, but with the continuing concern over the budget deficit, bond yields will be sticky in giving ground.

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Table 1
Net Funds Raised in the Credit and Capital Markets
(In billions of dollars)

	1980		1981		1980	1981
	1st Half	2nd Half	1st Half (est.)	2nd Half (proj.)		(proj.)
Nonfinancial Sectors						
Short-term						
Bank loans to business[1]	3.4	33.1	14.5	11.0	36.5	25.5
Open market paper[2]	22.2	—6.3	23.7	13.5	15.9	37.2
Finance company loans to business	—.1	2.0	4.0	2.7	1.9	6.7
Total business credit	25.5	28.8	42.2	27.2	54.3	69.4
Consumer instalment credit	—7.6	9.0	6.0	19.5	1.4	25.5
Life insurance policy loans	4.6	2.1	3.5	2.5	6.7	6.0
Farm credit agency loans	1.1	2.7	2.2	1.8	3.8	4.0
Total	23.6	42.6	53.9	51.0	66.2	104.9
Investment						
Corporate bonds	18.7	11.6	11.7	15.0	30.3	26.7
State and local bonds	8.2	13.5	7.9	9.5	21.7	17.4
Corporate stocks	3.0	6.5	5.7	4.0	9.5	9.7
Foreign bonds and stocks	2.1	.9	2.0	1.5	3.0	3.5
Mortgages	54.2	71.0	60.1	70.2	125.2	130.3
Total	86.2	103.5	87.4	100.2	189.7	187.6
U.S. Government Securities[3]	24.7	55.0	34.0	43.0	79.8	77.0
Total	134.5	201.1	175.3	194.2	335.7	369.5
Financial Sectors						
Open market paper	—.5	5.9	12.6	9.0	5.4	21.6
Corporate bonds	4.9	1.4	.5	1.5	6.3	2.0
Corporate stocks	.4	.2	.4	.4	.6	.8
Financial bank loans	—4.1	5.2	3.2	2.0	1.1	5.2
Nonbudget agencies (FHLB, FNMA, FFCA, FHLMC)	13.4	11.3	12.7	11.8	24.7	24.5
Total	14.1	24.0	29.4	24.7	38.1	54.1

[1] Includes corporate and noncorporate business, domestic and foreign, and agriculture.
[2] Includes bankers acceptances.
[3] Publicly held.

Table 2
Financing Business Corporations
(In billions of dollars)

	1980		1981		1980	1981
	1st Half	2nd Half	1st Half (est.)	2nd Half (proj.)		(proj.)
Cash Flow						
Undistributed profits	47.4	45.2	49.0	50.5	92.7	99.5
Capital consumption allowances	72.6	77.1	83.0	87.5	149.7	170.5
Total	120.0	122.3	132.0	138.0	242.4	270.0
Physical assets						
Plant and equipment	105.4	112.4	114.5	125.5	217.8	240.0
Inventories—book value	26.3	17.0	23.2	25.0	43.3	48.2
Residential structures	—1.5	4.1	2.0	2.1	2.6	4.1
Total	130.2	133.5	139.7	152.6	263.7	292.3
Physical assets less cash flow	*10.2*	*11.2*	*7.7*	*14.6*	*21.3*	*22.3*
Loans and securities						
Bonds	18.7	11.6	11.7	15.0	30.3	26.7
Tax-exempts	1.8	2.5	3.2	2.6	4.3	5.8
Stocks	3.0	6.5	5.7	4.5	9.5	10.2
Mortgages	8.4	12.9	10.0	9.5	21.3	19.5
Bank loans	4.9	28.8	13.2	10.0	33.7	23.2
Open market paper	13.5	—8.5	14.5	7.0	5.0	21.5
Finance company loans	—.1	2.1	4.0	2.7	2.0	6.7
Total	50.2	55.9	62.3	51.3	106.1	113.6
Other sources of funds						
Direct foreign investment	6.2	4.7	4.2	7.3	10.9	11.5
Unpaid taxes	—9.6	4.0	—5.5	6.0	—5.6	.5
U.S. Government loans	.6	.8	.1	.6	1.4	.7
Total	—2.8	9.5	—1.2	13.9	6.7	12.7
Other uses of funds						
Liquid assets	—.8	14.7	3.5	14.2	13.9	17.7
Investments abroad	7.8	10.2	2.0	3.0	18.0	5.0
Net trade credit	10.6	—8.0	14.0	—8.5	2.5	5.5
Total	17.6	16.9	19.5	8.7	34.4	28.2